

Message Text

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ACTION ARA-10

INFO OCT-01 ISO-00 AID-05 CIAE-00 COME-00 EB-07 FRB-03
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SP-02 LAB-04 EPG-02 SIL-01 OMB-01 AGR-05 /059 W
-----211308Z 123154 /50

R 202130Z MAY 77
FM AMEMBASSY BRASILIA
TO SECSTATE WASHDC 1761
INFO AMCONSUL SAO PAULO
AMCONSUL RIO DE JANEIRO

LIMITED OFFICIAL USE SECTION 1 OF 2 BRASILIA 4120

E.O. 11652: N/A
TAGS: ECON, EFIN, BR
SUBJ: BRAZILIAN GIMMICKING OF PRICE INDICES

REF: 75 BRASILIA 8195 (18 SEPT. 1976)

1. SUMMARY. THE CALCULATION OF THE RIO DE JANEIRO COST-OF-LIVING (COL) INDEX HAS BEEN MODIFIED TO PERMIT MONTHLY VARIATIONS IN THE INDEX WEIGHTS OF ITEMS IN THE TYPICAL MARKET BASKET. THERE HAS BEEN WIDESPREAD CRITICISM OF THE ACTION. THIS IS THE SECOND TIME THE GEISEL ADMINISTRATION HAS RESORTED OPENLY TO GIMMICKING PRICE INDICES. IN OUR JUDGMENT, THE ACTION WAS UNWISE AND DESPERATE, AND IT HAS HELPED FURTHER UNDERMINE CONFIDENCE IN THE GEISEL ADMINISTRATION. END SUMMARY.

2. IN EARLY APRIL, AS IT BECAME KNOWN THAT THE MARCH COST-OF-LIVING AND PRICE INDICES HAD RISEN SHARPLY FOR THE THIRD CONSECUTIVE MONTH, FINANCE MINISTER SIMONSEN EMBARKED ON A HEAVY-HANDED CAMPAIGN TO PRESSURE THE PRESTIGIOUS GETULIO VARGAS FOUNDATION INTO CHANGING ITS METHOD OF CALCULATING THE RIO COL INDEX. THE RIO
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INDEX IS SIGNIFICANT NATIONALLY BECAUSE OF ITS PSYCHOLOGICAL EFFECT, BECAUSE IT ACCOUNTS FOR 30 PERCENT OF THE NATIONAL GENERAL PRICE INDEX (DISPONIBILIDADE INTERNA), AND MOST IMPORTANTLY, BECAUSE IT ENTERS INTO IN THE MINISTRY OF LABOR'S NATIONAL WAGE ADJUSTMENT FORMULA. TO DRAMATIZE HIS POINT ABOUT THE DEFICIENCIES IN THE INDEX CALCULATION, SIMONSEN CLAIMED THAT PRICE

INCREASES IN "CHUCHU" (A BRAZILIAN VEGETABLE SOMEWHAT SIMILAR TO SQUASH) HAD ACCOUNTED FOR A ONE PERCENT RISE ON AN ANNUAL BASIS IN THE RIO COL INDEX SINCE THE BEGINNING OF THE YEAR. HE ARGUED THAT, IN CALCULATING THE INDEX, THE QUANTITY OF ANY PRODUCT USED TO MAKE UP THE MARKET BASKET SHOULD BE VARIED DEPENDING ON CHANGES IN THE PRODUCT'S PRICE RELATIVE TO THE AVERAGE PRICE OF SIMILAR (I.E., SUBSTITUTABLE) PRODUCTS. SPECIFICALLY, SIMONSEN FAVORED USE IN THE COL INDEX OF THE CONCEPT OF UNITARY ELASTICITY OF SUBSTITUTION BETWEEN PRODUCTS: FOR EVERY "X" PERCENT INCREASE IN PRICE RELATIVE TO THE AVERAGE PRICE OF "SUBSTITUTABLE" ITEMS THERE SHOULD BE AN "X" PERCENT DECREASE IN QUANTITY. THE GOVERNMENT APPARENTLY HAD NO EMPIRICAL DATA TO SUPPORT ANY SPECIFIC VALUE OF THE ELASTICITY OF PRODUCT SUBSTITUTION ON A MONTH-TO-MONTH BASIS BY CONSUMERS.

3. THE VARGAS FOUNDATION IS TECHNICALLY AUTONOMOUS, ALTHOUGH IT PERFORMS OFFICIAL STATISTICAL FUNCTIONS, RECEIVES SUBSTANTIAL FINANCIAL SUPPORT FROM THE GOVERNMENT, AND GENERALLY DOES NOT CHALLENGE GOB ECONOMIC POLICIES. UPON RELEASING THE MARCH STATISTICS, THE FOUNDATION ANNOUNCED THAT IT HAD ADOPTED THE MINISTER'S SUGGESTION AND INCORPORATED UNITARY SUBSTITUTION INTO ITS CALCULATIONS OF THE FOOD AND BEVERAGES PART OF THE INDEX. THIS CATEGORY HAS A 42 PERCENT WEIGHT IN THE INDEX. EVEN WITH THIS CHANGE, THE RIO COL INDEX FOR MARCH ROSE BY 4.2 PERCENT. UNDER THE OLD SYSTEM, LIMITED OFFICIAL USE

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ACCORDING TO SOME PRESS REPORTS, THE INCREASE WOULD HAVE BEEN ONLY SLIGHTLY GREATER. ON THE OTHER HAND, A FINANCE MINISTRY SOURCE TOLD CONGEN RIO OFFICERS THAT THE DIFFERENCE WAS LARGE, 0.8 PERCENTAGE POINTS. THE SOURCE ADDED, HOWEVER, THAT APPLICATION OF THE NEW FORMULA TO LAST YEAR'S PRICE DATA SHOWED LITTLE CHANGE IN THE INFLATION CALCULATIONS.

4. THIS LATEST EFFORT TO GIMMICK PRICE INDICES RECALLS THE GEISEL ADMINISTRATION'S DECISION IN AUGUST 1975 TO PURGE SO-CALLED "ACCIDENTAL FACTORS" FROM THE IPA, UP TO A CEILING OF 4 PERCENTAGE POINTS PER YEAR. (REFTEL) BOTH THE PURGED AND UNPURGED VERSIONS OF THE IPA ARE PUBLISHED MONTHLY IN THE VARGAS FOUNDATION'S "CONJUNTURA ECONOMICA." THE PURGED VERSION OF THE IPA IS USED IN CALCULATING THE MONTHLY MONETARY CORRECTION ADJUSTMENT. FROM JULY 1975 THROUGH JULY 1976, THE DIFFERENCE BETWEEN THE INCREASE IN THE UNPURGED IPA, 41.85 PERCENT, AND THE PURGED IPA, 39.37 PERCENT,

WAS 2.48 PERCENTAGE POINTS. IN THE SUCCEEDING EIGHT-MONTH PERIOD, JULY 1976 - MARCH 1977, THE GOVERNMENT MADE LESS USE OF THE PURGING TECHNIQUE. IN THAT TIME PERIOD, THE UNPURGED IPA INCREASED BY 27.53 PERCENT AND THE PURGED IPA BY 26.48 PERCENT, LEAVING A DIFFERENCE OF 1.05 PERCENTAGE POINTS. DURING THE FIRST QUARTER OF 1977, ONE PURGE

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INR-07 NSAE-00 USIA-06 TRSE-00 XMB-02 OPIC-03
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R 202130Z MAY 77
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INFO AMCONSUL SAO PAULO
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TOOK PLACE, 0.3 PERCENTAGE POINTS IN MARCH. THE JUSTIFICATION FOR THIS PURGE REPRESENTS AN EXPANSION OF THE CONCEPT OF "ACCIDENTALITY." THE "COTA DE PREVIDENCIA" TAX WAS TRANSFERRED FROM PUBLIC SERVICES TO GASOLINE AND OIL -- AND SINCE THE IPA DOES NOT INCLUDE SERVICES, THE TAX INCREASE ON GASOLINE AND DIESEL OIL WAS PURGED FROM THE IPA USED FOR MONETARY CORRECTION.

5. COMMENT. THE CONCEPT OF LESS-THAN-PERFECTLY-IN-ELASTIC SHORT-RUN ELASTICITY OF PRODUCT SUBSTITUTION IN THE MARKET BASKET HAS A THEORETICAL AND EMPIRICAL JUSTIFICATION, TO THE EXTENT THAT CONSUMERS DO ADJUST MONTHLY CONSUMPTION PATTERNS BASED ON CHANGES IN RELATIVE PRICES BETWEEN THE COMPONENTS OF THE FOOD AND ABEVERAGE CATEGORY. SIMONSEN APPARENTLY WAS GENUINELY CONCERNED THAT A FIXED-WEIGHT INDEX DID NOT REFLECT EMPIRICAL REALITY, AND THAT HIGH PRICE INDICES HAVE DIRECT AND INDIRECT INFLATIONARY RE-FUELING IMPACTS.

6. THIS NOTWITHSTANDING, NO REPUTABLE STATISTICAL

ORGANIZATION USES CONSTANTLY CHANGING WEIGHTS IN
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PRICE INDICES, FOR THIS WOULD RENDER THE INDICES USE-
LESS FOR INTERTEMPORAL PRICE COMPARISONS. IN ADDITION,
THE TIMING OF THE CHANGE (WHEN INFLATION WAS MISBEHAVING),
AND THE ABSENCE OF ANY RESEARCH TO VERIFY SHORT-RUN
CROSS-PRICE ELASTICITIES OF DEMAND FOR AFFECTED PRODUCTS,
HELPED TO CAUSE STRONGLY NEGATIVE PUBLIC REACTIONS.
THESE REACTIONS FURTHER UNDERMINED PUBLIC AND BUSINESS
CONFIDENCE IN THE QUALITY OF THE GEISEL ADMINISTRA-
TION'S ECONOMIC POLICIES, AND IN THE ADMINISTRATION'S
PUBLIC CREDIBILITY. THE NEGATIVE PSYCHOLOGICAL
EFFECTS OF THE ACTION SHOULD FAR OUTWEIGH ANY GAINS THE
GOVERNMENT MIGHT PERCEIVE IN TERMS OF LOWER REGISTERED
INFLATION RATES.

7. WE HAVE SEEN NO PUBLIC PROTESTS OR REFUSALS TO
ACQUIESCE ON THE PART OF HIGH OFFICIALS OF THE
VARGAS FOUNDATION. IN A CONVERSATION WITH THE E/C COUNSELOR,
JULIAN CHACEL, THE FOUNDATION'S DIRECTOR OF RESEARCH, PROFESSED
TO BE EMBARRASSED ABOUT THE WHOLE AFFAIR. IN THE PRESS AS
WELL HE HAS MADE NO SECRET OF HIS UNHAPPINESS WITH
FINANCE MINISTER SIMONSEN'S ACTION. NEVERTHELESS,
THE FOUNDATION'S RELATIVELY PASSIVE ACQUIESCENCE TO
THIS LATEST ACTION HAS EMBARRASSED THE FOUNDATION, AND
LEADS ONE TO WONDER WHETHER ANY OTHER MODIFICATIONS OF
STATISTICAL METHODOLOGY FOR THE COL AND OTHER INDICES MIGHT BE
TAKING PLACE. UNDOUBTEDLY WORRIED ABOUT ITS REPUTATION, THE
FOUNDATION HAS PROMISED TO PUBLISH AN EXPLANATION OF ITS NEW
METHODOLOGY FOR THE RIO COL INDEX.

8. TO US, THE MOST PERPLEXING THING ABOUT THE GIMMICKING
ACTION IS WHY THE GOVERNMENT DID IT. AS WE HAVE NOTED,
SIMONSEN APPARENTLY WAS GENUINELY CONCERNED ABOUT THE
QUALITY OF THE COL INDEX. ON THE OTHER HAND, HE
SURELY REALIZED THAT HIS METHODOLOGY CHANGE WOULD BE
SCORNE BY ECONOMISTS FOR TECHNICAL REASONS, AND BY
THE PUBLIC FOR POLITICAL REASONS. WE OURSELVES ARE NOT
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COMPLETELY SURE WHETHER HE GREATLY UNDERESTIMATED THE NEGATIVE
PUBLIC REACTION (AS HE DID SEVERAL MONTHS AGO WHEN HE
SUPPORTED THE NOW-REVERSED DECISION FOR GASOLINE
RATIONALIZATION), WHETHER HE ANTICIPATED THE REACTION
BUT THOUGHT THE BENEFITS WERE WORTH THE COSTS, OR

BOTH. WE CONJECTURE BOTH ARE TURE TO SOME EXTENT. AND
WE WONDER WHETHER THE DECISION NOT TO PUBLISH THE COL
CALCULATIONS BASED ON BOTH THE OLD AND NEW
METHODOLOGIES IS INDICATIVE OF THE GOVERNMENT'S PURPOSES.
WHATEVER THE PURPOSES THE GOVERNMENT HAD IN MIND, ITS ACTION
SEEMS UNWISE POLITICALLY, IN GREAT PART BECAUSE IT
SHOWED THE ECONOMIC POLICY-MAKERS AS DESPERATELY GROPING FOR
STRAWS.

9. THE EMBASSY AND CONGEN RIO DE JANEIRO PREPARED
THIS TELEGRAM.
CRIMMINS

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